



Extractive sectors and illicit financial flows: What role for revenue governance initiatives?

Philippe Le Billon

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What role for revenue governance initiatives?

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U4 Issue

October 2011 No 13



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Abstract

Countries highly dependent on natural resources are among the most severely affected by the problem of illicit financial flows. Despite a lack of definite studies proving the correlation between higher dependency on natural resources and higher levels of illicit flows, there are grounds to believe extractive industries' revenues provide a large contribution to these flows. Most existing initiatives to address governance issues in extractive sectors have not been designed with the problem of illicit financial flows in mind. They have generally contributed to increased levels of transparency in the sector but have not significantly influenced the likelihood that revenues from natural resources will be misappropriated and illicitly transferred. But extractive industries initiatives can be improved in this regard, and development aid, along with other stakeholders, can help. Among other priorities, transparency initiatives should demand higher disaggregation of information disclosed by extractive companies and host governments. Transparency requirements should extend beyond revenues to licensing, contracts, physical resource flows, and other production factors, as well as to public expenditure. Extractives transparency initiatives also need to integrate elements of the tax justice and tax evasion agendas in order to expand their relevance to the effort to reduce illicit financial flows.

Acknowledgments

The author would like to acknowledge the assistance of Sotonye Godwin Hart and Sara Elder, as well as support from the Social Sciences and Humanities Research Council of Canada.

Acronyms

AML/CFT	anti-money laundering and countering of financing of terrorism
ATAF	African Tax Administration Forum
BRIC	Brazil, Russia, India, and China
CSO	civil society organisation
CSR	corporate social responsibility
DRC	Democratic Republic of the Congo
DTC	double taxation convention
EI-TAF	Extractive Industries Technical Advisory Facility (in the Oil, Gas, and Mining Unit of the World Bank)
EITI	Extractive Industries Transparency Initiative
EU	European Union
FACT	Financial Accountability and Corporate Transparency
FCPA	Foreign Corrupt Practices Act
FLEGT	Forest Law Enforcement, Governance and Trade
GDP	gross domestic product
GTSP	Global Tax Simplification Program (of the World Bank/IFC)
IASB	International Accounting Standards Board
ICGLR	International Conference on the Great Lakes Region
IFC	International Finance Corporation
IFF	illicit financial flows
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
KPCS	Kimberley Process Certification Scheme
NGO	nongovernmental organisation
Norad	Norwegian Agency for Development Cooperation
NRC	Natural Resource Charter
OECD	Organisation for Economic Co-operation and Development
OfD	Oil for Development (programme run by Norad)
OSI	Open Society Institute
PWYP	Publish What You Pay
ROSC	Report on the Observance of Standards and Codes
RWI	Revenue Watch Institute
SEC	US Securities and Exchange Commission
StAR	Stolen Asset Recovery (initiative of the World Bank Group and the UN Office on Drugs and Crime)
TIEA	Tax Information and Exchange Agreement
UNDP	United Nations Development Programme

1. Introduction

Most countries do not reap the full benefits from their wealth in natural resources. One of the major causes is illicit financial flows (IFF), that is, money that ends up benefiting local and foreign elites rather than the general population. Much of this money is generated by corruption, illegal resource exploitation, and tax evasion.¹ Recently, given high commodity prices and record profits by resource companies, frustration with this issue has been growing—not only among the public in producing countries, but also among donor countries concerned with improving public finances in the midst of economic crisis.

There are currently at least a dozen international initiatives that seek to curb IFF. One of the most prominent is the Extractive Industries Transparency Initiative, focusing on financial flows between companies and governments. Individual countries have also taken measures. For example, one recent case resulted in a US\$1.2 billion settlement between US authorities and oil and gas service companies accused of corruption in construction of a liquefied natural gas plant in Nigeria.²

This U4 Issue Paper looks at the potential of these initiatives to reduce illicit financial flows from extractive sectors, particularly those initiatives that target resource revenue governance.³ Section 2 provides a brief overview of resource governance challenges and the nature of illicit financial flows in extractive sectors, highlighting consequences for development in poor countries. Section 3 summarises international initiatives to improve resource revenue governance, focusing on information disclosure and certification. It also discusses their comparative achievements and factors for success. Section 4 sums up the potential for these initiatives and suggests priorities within them as well as the possible need for additional actions.

¹ For a discussion of poor revenue governance, including ineffective revenue capture, poor management of revenue volatility, and inefficient revenue spending, see Humphreys, Sachs, and Stiglitz (2007) and Collier (2010).

² See US Department of Justice press release (<http://www.justice.gov/opa/pr/2010/July/10-crm-780.html>). In a case in China, former Sinopec chairman Chen Tonghai received a life sentence for accepting about US\$29 million in bribes between 1999 and 2007 (Macartney 2009).

³ The paper does not examine IFF and money laundering *through* extractive sectors. For guidance on this, see FATF (2008).

2. Extractive sectors and illicit financial flows

Extractive sectors currently generate about US\$3.5 trillion in annual gross revenue, corresponding to around 5 per cent of global gross domestic product (GDP). The oil sector dwarfs other extractive sectors, accounting for about 65 per cent of this overall figure, with coal and natural gas representing around 11 per cent each, and non-fuel minerals 13 per cent.⁴ Rents, or potential net revenues, are estimated at about US\$1 trillion for low-income and lower-middle-income countries, or about US\$200 per capita for a total population of 5 billion.⁵ Much of this money is lost by producing countries as a result of illicit financial flows (box 1).

Box 1. Defining illicit financial flows

Dev Kar, lead economist at Global Financial Integrity, defines “illicit financial flows” or “illicit money” as “money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.” According to the United Nations Development Programme (UNDP), “illicit [financial] flows include, but are not limited to, cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting.” In extractive sectors, these flows mostly originate from corruption, illegal resource exploitation, and tax evasion (including through smuggling and transfer mispricing). Although IFF are usually understood as the international flow component of corruption, this paper also deals with the domestic aspects of the problem, since corruption is a phenomenon that takes place domestically as well as internationally. Estimates of IFF are necessarily imprecise because of a lack of reliable data, and they also vary according to the methodologies used.

For a recent overview on IFF definitions and measurements, see Fontana (2010). For an assessment of relevance to developing countries, see UNDP (2011). Dev Kar's definition is available at <http://www.financialtaskforce.org/2010/08/16/illicit-financial-flows-from-developing-countries-the-absurdity-of-traditional-methods-of-estimation/>. The UNDP definition is available at <http://www.undp.org/bt/Perspectives-on-Issues-and-Options-for-LDCs.htm>.

2.1 The link between natural resources and illicit financial flows

Much evidence suggests that extractive sectors are associated with high levels of illicit financial flows. Some oil and mineral exporting countries are perceived as among the most corrupt. The release of statistical data by diamond producing and importing countries through the Kimberley Process Certification Scheme revealed that global production was nearly twice as large as previously estimated, underlying massive smuggling, underreporting, and tax evasion (Rodgers 2006). Fuel exporters accounted for nearly half of the illicit financial flows from Africa between 1970 and 2008, with Baker and Kodi (2010, 12) stressing that “acceleration in illicit outflows was undoubtedly driven by oil price increases.” This was principally a result of greater opportunities for trade mispricing, a result corroborating findings on capital flight from the Middle East and North Africa between 1970 and 2005 (Almounsor 2005).

⁴ For the period 2008–10, these broad estimates vary mostly with commodity price fluctuations (UNCTAD 2011).

⁵ Average annual rent estimated between 2000 and 2008 for countries with per capita GDP below US\$4,000. For low-income countries with per capita GDP below US\$1,000, the average annual rent for the same period is about US\$270 billion, equivalent to about US\$100 per capita. See World Bank Wealth of Nations database (<http://data.worldbank.org/data-catalog/wealth-of-nations>).

More broadly, resource-rich countries tend to underperform in revenue collection (measured by tax as a proportion of GDP). This is especially the case in Sub-Saharan Africa, where a higher share of fuel in total exports is associated with higher levels of IFF and revenue lost to the state (Ndikumana and Abderrahim 2010; Ndikumana and Boyce 2011). Boyce and Ndikumana (2011) find a statistically significant positive relationship between oil exports and illicit financial flows; for each extra US dollar in oil exports, they estimate that an additional 11 to 26 cents leaves the country as illicit capital flight. More broadly, recent findings also indicate that high natural-resource dependence reduces the level of transparency and increases corruption (Williams 2010). More detailed econometric studies, a task which falls beyond the scope of this paper, would be required to confirm these results.

Several factors make extractive sectors prone to illicit financial flows (Gillies 2010). First, extractive sectors tend to come under high-level discretionary political control, which can facilitate IFF. High concentration in resource sectors (in terms of geographic location, exploitation, and control of revenues) and the fact that they account for a majority of foreign earnings and fiscal revenues in many countries makes control over resource sectors a powerful instrument of economic and political power. As such, they often are controlled by the president's office and a small cadre of technocrats and are particularly prone to secrecy. Discretionary funds generated by extractive sectors increase political leaders' autonomy from the population and external donors, thereby reducing accountability and openness to reform.

Second, there is frequent blurring of public, shareholder, and personal interests with regard to extractive sectors. State companies, especially in the oil and gas sectors, may serve the personal interests of their political patrons. Government officials may have vested financial interests in companies in the sector. In public as well as private companies, senior management may benefit from excessive compensation packages.

Third, competition is often limited. This results in fewer checks and balances in these sectors compared to other more competitive sectors. With stable oligopolies, nominal competitors may in fact collaborate in IFF (Martin and Park 2010).

Fourth, extractive sectors involve complex technical and financial processes that require a high degree of expertise. Oil companies themselves, rather than governments, do much of the accounting for tax payments, especially in developing countries. This opens the door to manipulation, particularly if auditing capacity is limited or corrupt. High reliance on taxes on profits encourages cost inflation and facilitates mispricing by companies.

Finally, resource-rich countries tend to have a high degree of integration into the global economy, but through a limited number of channels, particularly resource exports and imports of food and manufactured goods. These open lucrative opportunities for IFF.

Box 2. Distinguishing between illicit and illegal activities

The terms "illicit" and "illegal" distinguish between what is morally reprehensible and what is legally prohibited. To take two examples: gold panning by women in the wastewater of a sorting plant within a mining concession in Sierra Leone is illegal. However, it is perceived as licit by the local community and by mining company staff. On the other hand, the claim of a New York-based "vulture fund," which purchased a 1980s Yugoslav loan of US\$34 million to obtain at least US\$116 million from the Democratic Republic of the Congo (DRC) government, including a Chinese mining contract signature bonus, is legal, according to courts in South Africa, the Jersey Islands, and Hong Kong. But it is still viewed as illicit, not only in the DRC, but also in the international development community.

Illicit practices, therefore, may be legal but still be perceived as ethically wrong, given the norms of a particular community. This underscores the importance of ethical standards within professional communities dealing with illicit financial flows, such as lawyers and accountants. Ethical norms need to be dictated by codes of conduct and possibly certification by professional bodies at the international level to address regulatory gaps in national jurisdictions (Global Witness 2011; Mao 2011).

2.2 Sources of illicit financial flows from extractive sectors

This paper identifies three sources of illicit financial flows derived from extractive sector revenues, each from operations rewarding different beneficiaries (see table 1). The first source consists of the proceeds of corruption, involving the abuse of public authority for personal interest at the expense of the broader community. The second source consists of revenues from illegal resource exploitation in which the state is blocked from receiving its legal share. The third source is tax evasion. These three sources are not mutually exclusive, but are often found together. For example, a company might pay a bribe to illegally exploit a resource outside its concession area. The product may then be shipped without export duties, the bribe itself being paid to an overseas account.

Table 1. Main types of illicit financial flows and beneficiaries

	Corruption	Illegal exploitation	Tax evasion
Main financial flows	Facilitation payments (bribes) paid by companies, money embezzled from tax collection and budgetary allocation	Undeclared corporate revenues from illegal resource exploitation	Inflated costs deducted from taxable revenues, smuggling of resources
Main beneficiaries	Corrupt government officials and companies gaining undue advantage	Domestic companies, local subsidiaries of foreign companies	Parent or holding companies, exporting companies

2.2.1 Corruption

Corruption is often presented as “*the* development problem in resource-rich countries, rather than just one of a number of problems” (Kolstad and Søreide 2009, 214, emphasis added). Large resource revenues facilitate rent seeking and patronage, resulting in higher levels of corruption, diversion of time and talent from productive activities, inefficient public spending, and low political accountability. There is evidence that illicit financial flows are intimately linked to large-scale corruption in developing countries (Reed and Fontana 2011).

Illicit financial flows from many developing countries derive from the poor governance of extractive industries. Of the “top 10” corrupt political leaders in developing countries identified by Transparency International (2004), three ruled in extractive sector-dependent countries: Nigeria, Indonesia, and Zaire (now Democratic Republic of the Congo). In Egypt, former energy minister Sameh Fahmy was arrested in relation to a 15-year gas supply deal with an Israeli company that would have brought a US\$714 million loss for the Egyptian state. The deal would have resulted in massive kickbacks for Egyptian officials and handsome profits for Mubarak’s business ally Hussein Salem (Carlisle 2011).

Corrupt practices, in turn, are frequently linked to the two other sources of illicit financial flows. The bribing of midlevel resource management officials, for example, enables illegal resource exploitation outside of concession areas. Corruption also facilitates tax evasion, with bribes undermining the maximisation and collection of monetary revenues including bonuses, royalties, fees, and corporate taxes, or physical production shares (see table 2). In some sectors, such as logging and diamond mining, production companies and exporters routinely bribe officials to underreport the volume or value of resources. Corruption can take place at all levels of the value chain, beginning with the initial

bidding and contractual process (see table 3).⁶ Resource income (measured as resource rent per capita) is associated with higher levels of perception of corruption, and in turn with poor economic performance (Leite and Weidmann 2002). This relationship is stronger for extractive sectors, more so for fuel than non-fuel mineral exports. The correlation is most robust for countries with low-quality democratic institutions (Isham et al. 2005; Petermann, Guzmán, and Tilton 2007; Bhattacharyya and Hodler 2010).

Table 2. Revenue streams and risks of illicit financial flows

Revenue stream	Illicit financial flow risks
Bonuses	Bribes and payments outside central budget accounts, associated with embezzlement and political slush funds
Royalties	Underreporting of volume, underestimated value, price discount, benchmark or indexation
Fees	Petty corruption related to extortion or payment avoidance
Corporate income taxes	Transfer mispricing/over-invoicing, undue tax exemptions or rebates
Production share	Misreporting on volume or quality by operating company, inflation of operational costs, embezzlement by state resource marketing entity

2.2.2 Illegal resource exploitation

Illegal exploitation in extractive sectors includes a broad range of practices, many of which contribute directly to illicit financial flows. These include operating outside the confines of licensed areas, such as by extracting resource from outside a concession, or beyond contractual limitations, such as by extracting extensive quantities of mineral under an “exploration” license that only authorises sampling—a common practice in medium-scale mining of shallow deposits of high-value minerals (e.g., relatively small and poorly monitored open-cast diamond mines). Theft is a common issue in extractive industries. About 30 tons of gold were suspected of being stolen from South African mines every year in the mid-1990s, with the government losing approximately 13 per cent of its potential revenues from the sector (Gastrow 2001).

Underreporting the volume or quality of resource produced (e.g., through biased oil volume measurements or misreporting of ore grade) is also common, especially when measurement involves technical expertise and equipment. Accurate volume reporting for tax purposes is a major concern in many countries, including such high-profile cases as Iraq and Nigeria (McPherson and MacSearraigh 2007). More broadly, illegal resource exploitation also includes failure to respect environmental and social regulations, such as policies on wastewater disposal or on workers’ exposure to chemicals. Compliance with environmental and social regulations is costly for companies and thus open to corruption, through compliance avoidance, lowering of standards, or demand for “facilitation payments” by officials. Arguably, non-compliance also generates illicit financial flows benefiting the company by illegally increasing profits (especially if these are not taxed or companies declare false compliance expenses).

The Democratic Republic of the Congo and Nigeria are among the countries most affected by the illegal exploitation of resources. Several Congolese commissions and UN panels of experts have documented illegal mineral exploitation and exports, some of which finance armed groups in the DRC,

⁶ For a discussion of corruption in relation to corporate tax avoidance and tax havens, see Dine (2007) and Shaxson (2011).

especially in the eastern part of the country. Even in the diamond sector, which comes under international monitoring through the Kimberley Process (see below), about 30–50 per cent of the production by value is reported to be exported without proper declaration or valuation (World Bank 2008; Solvit 2009). Estimates of oil theft or bunkering in Nigeria reached at times as high as 300,000 barrels per day between 2001 and 2008.⁷ In both cases, the notion of illegality needs to be complemented by perspectives on the licit character of such exploitation. In some estimates, 85 per cent of illicit oil flows result from elite corruption rather than militant operations, although the two are difficult to disentangle (Asuni 2009; Vanguard 2011).

2.2.3 Tax avoidance and evasion

Tax avoidance starts with the negotiation of contracts, set within the broader framework of extractive sector taxation policy. Companies seek a “favourable investment climate” with low taxes via broad fiscal reforms or specific contractual arrangements. While not *stricto sensu* illegal, unless obtained through corrupt practices or outright coercion, the very favourable fiscal regime or contractual terms obtained by some extractive companies make them illicit in the eyes of the domestic population, resulting in legitimacy issues for local authorities and corporations.⁸ Additionally, contracts are frequently negotiated not with resource companies in their home country but with subsidiaries incorporated in low- or no-tax jurisdictions. This insures companies against tax payments agreed under bilateral tax treaties. Profits routed through the subsidiaries’ low-tax jurisdictions are then passed on to the company’s group, often through the proceeds of high-interest loans, in order to also avoid taxes in the home country.⁹ Both host and home countries lose, while untaxed profits accrue to the subsidiary in the tax haven (Brown 2008; Palan, Murphy, and Chavagneux 2010).

Such advantageous fiscal terms are most often the result of general policies of liberalisation pursued since the early 1990s (Bridge 2004). But they are also sometimes the result of corruption, with payments by companies to public officials to secure better terms. Such corruption can be initiated by investors seeking higher returns who find corrupt elites willing to accept direct bribes or similar benefits such as lucrative service contracts. Very attractive investment conditions can also be offered by political elites in the hope of generating large initial payments, such as signature bonuses, which can be embezzled (or used to address short-term priorities unrelated to the long-term national interest). Similar mechanisms can be behind the privatisation of public companies, renegotiation of contracts, or reallocation of concession areas. This could have been the case recently in the Democratic Republic of

⁷ “Oil theft” is an expression used by Niger Delta militants to describe official production benefiting the government and oil companies. Peaceful movements for greater local control of oil resources have been met with repression by government security forces, which in turn has spurred unrest and militant radicalisation; this is the context in which corrupt elites orchestrate illegal oil flows. “Bunkering” is used in Nigeria to mean the illegal tapping of oil from pipelines or loading at oil terminals. The term is more commonly used to describe the loading of oil on cargoes at sea.

⁸ See, for example, Lungu (2009); Campbell (2011). Examples include long tax holidays (10 years is frequent), full write-off of capital costs, exemption from import and often export duties as well as many other domestic taxes, special transfer pricing arrangements (including resource pricing based on costs and fixed markups rather than international market price), capitalisation through “debt” with financial institutions affiliated to the same company and located in a low-tax jurisdiction, minimal royalties (3.5 per cent is becoming the norm in mining), and low corporate profit tax (15–20 per cent).

⁹ In a sample of 111 resource companies operating in Australia between 2003 and 2006, 25 per cent were part of a corporate group with “at least one member company incorporated in an OECD registered tax haven” (Taylor, Tower, and Van der Zahnet 2011). The proportion is expected to be much higher for medium to large resource companies operating in developing countries.

the Congo, where US\$23.7 million may have been embezzled from a US\$100 million signature bonus for a copper mining contract.¹⁰

Once a contract is in place, a second stage of tax avoidance involves aggressively seeking all possible tax advantages (Benari 2009). The most common way of doing this for profit-based taxes is to inflate costs and thus reduce taxable earnings through over- or under-invoicing. This is generally done through transfer mispricing that advantageously sets prices for internal transactions between two subsidiaries of the same corporation (Hollingshead 2010).¹¹ Typically, a subsidiary in the producing country purchases goods (such as an oil platform) and services needed for resource production, or sells resources (such as mineral ore) to another subsidiary located in a low-tax jurisdiction. The main objective of transfer pricing is to determine the fair (or arm's length) price of a good or service sold across jurisdictions within a business group in order to avoid a double taxation of its revenues. However, parent companies can abuse the system to reduce the taxation of profits. Such tax abuses are common, long-recognised, and costly to producing countries (Lall 1979; Sikka and Willmott 2010).

Tax avoidance becomes tax evasion when tax regulations are broken, and tax fraud when falsified papers are involved. Several reports focusing on Southern Africa's mining sector highlight tax regimes unfavourable to host governments, lack of auditing, and cases of tax evasion and fraud (Christian Aid 2008, 2009a, 2009b; Kangamungazi 2009). Underreporting production and underpricing minerals appear to be two major channels for tax evasion in the mining sector, in part because of uneven and inadequate enforcement by tax authorities. Corruption and collusion within a broader context where oversight and accountability are lacking also facilitate such practices (see box 3). Underreporting was estimated at up to 74 per cent in a silver mine in the Philippines, while revenues lost through the nonpayment of royalties were assessed at about US\$140 million per year in Peru between 2004 and 2006 (Christian Aid 2007, 2009c). Transfer pricing has been systematically researched only with respect to the US and Canadian oil industries, with the most recent study on the United States contradicting an earlier one on Canada showing a positive incidence of mispricing (Bernard and Genest-Laplante 1996; Jenkins and Wright 1975).

Box 3. Tax incentives and tax evasion: Zambia case study

Glencore and First Quantum Minerals have faced allegations of having manipulated the financial accounts of their Mopani Copper Mines in Zambia to evade taxation. This happened while they were operating within a "highly attractive fiscal environment" that featured exemptions on customs duties, a 0.6 per cent royalty tax rate, a corporate tax rate limited to 25 per cent, and a 20-year stability clause. A 2009 audit suggested overestimation of operating costs, underestimation of production volumes, transfer pricing manipulation, and breach of the "arm's length" principle. Nongovernmental organisations made complaints to the Organisation for Economic Co-operation and Development (OECD) National Contact Points in Switzerland and Canada (home countries of Glencore and First Quantum, respectively) for breach of the OECD guidelines on taxation.¹ Mopani Copper Mines denied the allegations (Doward 2011; OECD Watch 2011).

¹⁰ Just weeks before it was supposed to receive part of the US\$100 million signature bonus, Gécamines was required to pay out US\$23.7 million in "debt" to a previously unheard-of company registered in the British Virgin Islands (Global Witness 2011).

¹¹ Similar techniques include multiple invoicing for one shipment, short- or over-shipping less/more goods than declared, obfuscation of type of goods, and phantom shipping of no goods at all, with a false paper trail (see Wolfsberg Group 2009). These methods can also be used by colluding companies that are not formally affiliated.

2.3 Illicit financial flows and the resource value chain

The risk of illicit financial flows varies widely during the project cycle and along the value chain of extractive sectors. Table 3 highlights some of these risks for the three major types of illicit financial flows. Further risks exist in the allocation of resource revenues, including embezzlement and tax evasion connected to imports.

Table 3. Resource value chain and IFF risk level

Activity	Risk level		
	Corruption	Illegal exploitation	Tax evasion
Licensing	High, through award criteria, information access, and selection process	Low, except for overriding normally prohibited resource exploitation (e.g., in national park)	High, through setting fiscal framework
Exploration	Low, except for ensuring investment schedule and presentation of survey results	Low, except for medium- scale placer mining of high-value minerals	High, through expenditure inflation
Development	High, through contract amendments, cost-recovery and production-profile plans, and construction phase	High, through agreement on future production monitoring	High, through procurement over-invoicing
Production	High, through application of production regulations and contract amendments	High, including through fraudulent measurements and underreporting	High, through transfer mispricing and over-invoicing
Trading and transportation	High, through resource purchase contracts, shipment authorisation, and pipeline access	High, through diversion of resource flows and racketeering by transporters	High, through transfer mispricing and under-invoicing
Refining and marketing	Medium, through circumventing price controls and award of importing and retailing contracts	High, through diversion of refined resources and racketeering by transporters	Medium, through smuggling of untaxed or subsidised products
End phase	Low, except for decommissioning expenditures including environmental mitigation	Low, except for post-decommission "illegal" exploitation	High, through early exit or false bankruptcy
Revenue allocation	High, through embezzlement, "pork-barrelling," "white elephant" projects, and inefficient "populist" policies	Low, except through effect of low revenue allocation to regulation of extractive sectors	High, through under-invoicing of imports

Sources: McPherson and MacSearraigh (2007), Al-Kasim, Søreide, and Williams (2008), Kolstad and Søreide (2009); author.

2.4 Illicit financial flows and different extractive sectors

Different extractive sectors are exposed to distinct risks of illicit financial flows, reflecting the specific characteristics of the resources and modes of production involved. Table 4 highlights the risks for four different extractive sectors.

Table 4. IFF risk levels for different extractive sectors

Sector	Risk level		
	Corruption	Illegal exploitation	Tax evasion
Oil	High, due to confidentiality and concentration of decision making and monitoring	High, due to biased metering, siphoning, and bunkering	Medium, due to homogeneity of international prices according to oil quality
Gas	Medium, due to limited market options	Low, since gas theft is very difficult except at transit hubs between markets	High, as gas prices vary widely because of fragmented markets
Industrial mining	High, due to confidentiality and concentration of decision making and monitoring	Low, except in measurement and ore grading	High, due to transfer mispricing
Artisanal mining	Medium for grand corruption but high for petty corruption, due to diffuse resource flows except at official export channel	High, due to accessibility of deposits and difficulties in monitoring	High, due to smuggling

Source: Author.

The size of illicit financial flows usually varies with the size of the resource sector. More resources provide a larger potential for IFF. Levels of IFF also depend on resource dependence, or the relative importance of the extractive sector to the economy and government revenues. If a country's resource dependence is low, it generally means that the economy is diversified and that extractive IFF will have a lesser developmental impact. Low dependence is also likely to indicate that relatively strong institutions are already in place, which reduces the risk of IFF. This is the case, for example, in Norway. Conversely, high dependence signals an undiversified economy, and most often weak political institutions as well. Thus, the risk of IFF having major negative developmental effects is highest for countries with high dependence, such as Nigeria. The structure of the sector also affects IFF. High concentration of revenues under the discretionary power of a few individuals, as in the oil sector, leads to very high risk. In contrast, low concentration of revenues, as in artisanal mining, reduces the risk of large IFF, although the cumulative impact of small flows may still cause significant damage.

2.5 Impact of illicit financial flows on the development of poor countries

The Norway-sponsored Task Force on the Development Impact of Illicit Financial Flows (2008) has stressed the negative development impacts of IFF and particularly those coming from natural resource sectors in developing countries. The Task Force observes that IFF undermine health, development, and government legitimacy, while increasing debt, aid dependence, and the risk of economic crises. Quantitative studies specifically testing for these impacts are lacking, largely because of the relative

novelty and persistent uncertainty of IFF data. However, it is estimated that developing countries experienced approximately US\$1.2 trillion in illicit flows during 2008, 10 times the amount of overseas development assistance provided by members of the OECD Development Assistance Committee that year (Kar and Curcio 2011).

A major concern of extractive sector governance is the collection and allocation of revenue flows to maximise government revenue share, eradicate corruption, and ensure fair and efficient use of the revenues. Illicit financial flows constitute a serious threat to several objectives:

- IFF coming from corruption encourage such illegal activities by establishing transfer networks that facilitate the outflow of proceeds. Corruption undermines the sound governance of resources, notably by facilitating illegal exploitation and poor environmental and social practices, as well as by eroding the tax base.
- IFF undermine the maximisation of government revenues through tax evasion practices, including transfer mispricing and misinvoicing. African governments have been particularly vulnerable to this, in part because of “inadequate institutional capacity to ensure tax compliance” (ATAF 2010, 1). In turn, this significantly reduces the contribution of mineral resource revenues to national development.
- IFF exacerbate inequalities (by increasing private gains for a few at the expense of public gains for the many) and inefficiencies (by resulting in suboptimal policies). Because national companies are less able to lower their effective tax rates, trade mispricing advantages multinationals. This, in turn, negatively affects the domestic private sector. The developmental impact of domestic companies, moreover, is frequently undermined by predatory practices. There is a fine balance between granting sufficient autonomy to a national resource company to allow it to thrive, and controlling it so it does not become self-serving.
- IFF discourage accountability and encourage discretionary decision making, short-term thinking, and favouritism by bureaucrats and officials. These practices, in turn, drastically reduce total earnings that a country derives from extractive assets.

3. International initiatives to improve governance of resource revenue

Sound management of resource revenue is now widely recognised as crucial to development outcomes, and many donors are focusing on greater financial self-reliance by developing countries. In this context, issues relating to corruption and tax evasion, both related to illicit financial flows, are gaining attention. Several international initiatives are attempting to address these problems by improving transparency and accountability in resource revenue flows. The Extractive Industry Transparency Initiative, for example, fosters public reporting on financial flows between resource companies and governments. Combining management principles with capacity-building and peer-pressure activities, these initiatives have targeted countries such as oil-rich Angola, where tax payments by companies are confidential, budgeted expenditure and actual outcomes are not compared, and “audit reports are not prepared” (Isaksen et al. 2007, vii).

These initiatives in the extractive sector fall in four main categories:

- Contract and revenue transparency instruments
- Certification instruments
- Broad governance standards
- Other non-resource-specific initiatives, including tax reform initiatives (Taylor, Tower, and Van der Zahn 2011)

Sections 3.1 to 3.4 below discuss how current initiatives in these four broad categories address the problem of IFF derived from natural resources.

3.1 Contract and revenue transparency instruments

Recent international efforts to address resource revenue governance challenges posed by IFF have been devoted mostly to improving contract and revenue transparency. Contract transparency initiatives in particular have made some headway since 2010. Several large meetings to build consensus have taken place, with the participation of civil society organisations (CSOs) and some lending agencies, and International Finance Corporation guidelines now require contract transparency. A few countries, including East Timor, Liberia, and the DRC have enshrined this principle in law, while Ghana has pledged official support for publication of contracts. The World Bank has made supportive statements and taken some action. Contract transparency, if well utilised, not only can help citizens know if they are getting a “fair deal,” but also can assist in monitoring compliance.

For revenues, the three main initiatives are the Extractive Industries Transparency Initiative, section 1504 of the US Dodd-Frank Wall Street Reform and Consumer Protection Act, and reforms of the International Financial Reporting Standards.¹² The Publish What You Pay campaign, a coalition of nongovernmental organisations (NGOs), has been a leading advocate for transparency in resource revenues. These efforts have had some impact on transparency, but their impact on reducing illicit financial flows is not yet demonstrated.

¹² For additional background, see <http://www.publishwhatyoupay.org> and <http://www.eitransparency.org>. Other transparency initiatives include the International Monetary Fund’s *Guide on Resource Revenue Transparency*, first issued in 2005 (IMF 2007; also see section 3.1.3 of this paper), as well as the Global Reporting Initiative, the United Nations Global Compact, and the European Transparency Initiative.

3.1.1 Extractive Industries Transparency Initiative

The Extractive Industries Transparency Initiative (EITI) “aims to strengthen governance by improving transparency and accountability in the extractives sector.” It is a voluntary initiative, in which governments agree to minimal criteria in order to participate and gain compliance status. The criteria require extractive companies (including state companies) to publish their payments to governments; governments to publish what they receive in revenue from companies; and an independent audit to reconcile these reports and identify discrepancies. In addition, the initiative requires the active participation of civil society in the design, monitoring, and evaluation of the audits (EITI 2011a, 2011b). The initiative broadly raises reporting standards and helps legitimate civil society involvement in governance. By March 2011 the EITI had validated 11 countries, and 24 other countries were working towards compliance validation. Several countries long targeted by EITI, including Angola (which initially motivated Global Witness to launch transparency initiatives), are not participating in the initiative. Some early participants such as Sierra Leone, which in 2006 declared its intention to implement the EITI, were not yet validated by mid-2011.¹³

A recent but disputed review suggested that “although the EITI has been very useful in directing the international community’s attention towards the extractive sector, it has not been able to significantly lower corruption levels” (Olcer 2009, 5). Among the reasons may be that EITI focuses exclusively on revenue flows (taxes, royalties, and other fees), ignoring expenditures, and that it targets countries lacking the conditions for transparency to become effective (Frynas 2010). More broadly, some observers doubt the effectiveness of transparency of revenue collection in reducing corruption, arguing that most corruption is related to expenditures (Kolstad and Wiig 2009). Doubts have also been raised from the beginning about the prospects for active promotion of the EITI beyond Western policy circles. Key oil-producing countries, such as the members of the BRIC bloc (Brazil, Russia, India, China), Venezuela, and the Persian Gulf countries, are unlikely to adopt the EITI process, even when their companies comply with similar standards adopted nationally.¹⁴

Three major factors have hampered EITI’s effectiveness:

- its narrow mandate focused on company-government financial flows;
- insufficient disaggregation and standardisation of financial disclosure to ensure credible and meaningful transparency (Gillies 2011); and
- reliance on weak civil society mechanisms for government accountability, as illustrated by the revenue management mechanism established in Chad in connection with the World Bank-funded Chad-Cameroon pipeline (Aaronson 2011; also see box 4).

Attempts to broaden the scope of the EITI have been resisted by most EITI participants, who cite concerns about overextending the initiative beyond its capacity. A few individual countries, such as Liberia, have chosen to apply EITI practices to other resources. Significantly for effectiveness, while the initiative requires audits to follow international standards, it only encourages (rather than requires) financial reporting disaggregated by company or project as well as consolidated figures. Both the lowest levels of disaggregation and the least capacity to use disaggregated figures are likely to occur in countries with the lowest level of CSO autonomy and capacity, both reflecting and compounding the lack of accountability (EITI 2011b, 23). The EITI has recently revised its validation criteria to ensure

¹³ A few governments have been expelled from the initiative, including Equatorial Guinea, which demonstrated the application of minimal validation criteria but also the limits of such a voluntary approach. Others, such as Angola, have chosen to leave the process.

¹⁴ This observation is still largely valid (Morrison and Wilde 2007).

more meaningful civil society participation, but this is not likely to be sufficient to resolve such issues.¹⁵

3.1.2 Dodd-Frank Act, Section 1504

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama in July 2010, provided for financial regulatory reforms following the 2008 financial crisis. Section 1504, on disclosure of payments by “resource extraction issuers,” mandates the US Securities and Exchange Commission (SEC) to require each such publicly listed company to disclose “information related to any payment made by [it], a subsidiary, or any entity under its control to a foreign government or the U.S. Federal Government . . . for the purpose of the commercial development of oil, natural gas or minerals.”¹⁶ The SEC has delayed its issuance of final rules, possibly to December 2011.¹⁷

This legislation is notable both for its mandatory character and for including disaggregation of payments by “type and total amount . . . for each project . . . and to each government.” Mandatory disaggregation of tax payments on a country basis, known as country-by-country reporting, has been a holy grail for advocacy groups seeking to curb tax evasion and improve tax returns for poor countries.¹⁸ The hope is that such disclosure, by allowing comparisons of companies within a country and within a sector across countries, will be a useful tool for identifying suspiciously low tax rates as well as corruption and embezzlement.

Several oil companies supportive of the EITI have condemned the disclosure requirements of the Dodd-Frank Act. They argue that these would require SEC-regulated companies to violate sovereign laws and that the provision is discriminatory, since only companies listed in the United States would be required to comply (MacNamara and Thompson 2011).¹⁹ According to one critic, Section 1504 is “imposing far more intrusive disclosure requirements [than the EITI] on those firms that are at the forefront of the effort to encourage transparency, while effectively exempting those companies that are least committed to transparency and largely immune from any obligation to disclose at all.” The latter would include most of the national oil companies that now control most of the world’s oil reserves (Aldonas 2011, 10). Secretive governments would supposedly prefer to work with companies that do not have to abide by Dodd-Frank disclosure requirements, making detailed disclosure a commercial risk for companies in compliance. The new EITI chair, Clare Short, however, expects that Dodd-Frank will push US issuers to encourage host governments to adopt the EITI, so that “you don’t get the big guys caught while the Chinese and the small ones do what they like” (Guest 2011). The Hong Kong stock exchange also has similar requirements for newly listed companies, while France, the United Kingdom, and some European Union officials have also made commitments to establishing such mandatory disclosure requirements.

¹⁵ In 2008, the government of Gabon lifted a ban on 22 NGOs critical of its revenue management after realizing that the ban was incompatible with its EITI membership (Reuters 2008). Yet the most prominent civil society advocate was prevented by the Gabonese government from attending the 2009 EITI Global Conference.

¹⁶ Section 1504 builds on the Energy Security through Transparency Act co-sponsored by senators Benjamin Cardin and Richard Lugar in 2009.

¹⁷ Final rules will be available on the SEC website at <http://www.sec.gov/rules/final.shtml>.

¹⁸ Disclosure of information for all countries in which companies operate (directly or through their subsidiaries or intermediaries) is necessary to avoid loopholes. Country-by-country reporting refers to accounting standards requiring disclosure on a country-by-country basis. For more information, see the Tax Research UK blog at <http://www.taxresearch.org.uk/Blog/category/ifrs-8/>.

¹⁹ According to a Publish What You Pay member, oil companies did not expect such stringent disclosure requirements to pass into law; they either neglected the US Congress consultation process or avoided it in order not to give it legitimacy (interview, Paris, March 2011).

3.1.3 IMF Reports on the Observance of Standards and Codes

The International Monetary Fund (IMF) plays a major international role in public finances, including through its requirements for fiscal revenue disclosure and fiscal management standards. The IMF's statistical country reports have provided a valuable source of information on fiscal revenues from extractive sectors for many countries. The IMF also issues Reports on the Observance of Standards and Codes (ROSCs), which serve both as quasi-audits for domestic authorities and as tools for risk assessment by investors and lenders. Of the 12 areas covered by ROSCs, two are of particular relevance for IFF: (a) anti-money laundering and countering the financing of terrorism (AML/CFT), and (b) fiscal transparency.²⁰ The IMF has issued a specific *Guide on Resource Revenue Transparency*, which applies the principles of the Code of Good Practices on Fiscal Transparency to resource-producing countries (IMF 2007). By 2010, the IMF had reported on fiscal transparency in 14 resource-dependent countries.²¹ Where the ROSC identified specific issues of concern, such as lack of transparency in revenue flows between national oil companies and the government, there were in most cases no clear consequences for "audited" countries. The IMF has so far not issued a specific guide on AML/CFT for resource-rich countries. This, however, is an area that deserves attention, with respect both to resource-based IFF and to conflict resources.

3.1.4 International Financial Reporting Standards

The International Accounting Standards Board (IASB) maintains accounting disclosure standards for extractive sectors, including the most widely applied accounting standards, the International Financial Reporting Standards (IFRS). The IASB has considered the specificities of extractive sectors since 2004. In recent years, the IASB has come under growing pressure from NGOs and the European Parliament to require extractive companies to disclose their public accounts on a country-by-country basis, including payments to governments, production volumes, production revenues, costs, turnover and profits, the names of key subsidiaries and properties, and reserves.²² A survey of accountants by the IASB advising team found general support for these proposals but led the team to recommend higher-level (regional) disaggregation rather than country-level or project-level disaggregation, as requested by civil society organisations such as Publish What You Pay (IASB 2010). The IASB is expected to take a decision by mid-2011. Potentially, this information could help at least flag some potential IFF occurrences, including illegal exploitation (through reconciliation of production volumes with other available figures) and tax evasion (through rough calculation of the effective tax rate).²³ Despite an expected large volume of data, however, it is unlikely to result in systematic flagging unless major efforts are made to consolidate the analysis capacity of civil society organisations, media, and parliamentarians. This is a task that several major NGOs, including Revenue Watch Institute (see below), have pursued for many years.

²⁰ For more information, see "Reports on the Observance of Standards and Codes (ROSCs)" on the IMF website, <http://www.imf.org/external/NP/rosc/rosc.aspx>.

²¹ These included Algeria (2005), Cameroon (2000, 2010), Equatorial Guinea (2005), Gabon (2006), Ghana (2005), Guatemala (2006), Indonesia (2006, 2010), Iran (2002), Kazakhstan (2003), Kyrgyz Republic (2002, 2008), Norway (2009), and Russia (2004).

²² See "Accounting Standards Regulations" on the Publish What You Pay website, <http://www.publishwhatyoupay.org/en/activities/advocacy/accounting-standards-regulations>. Some NGOs have noted, however, that the IASB is a private body serving the interests of corporate shareholders and capital providers; as such it has received funding from the major accountancy firms, "all of which have been found in breach of financial regulations" (Christian Aid 2008, 2009b).

²³ The proposal tabled by the IASB falls short in several ways. Multinational corporations would not be obliged to report on all countries where they have activities. They could opt out if data could "prejudice" them. And the proposal does not include country-by-country reporting on production revenues, subsidiaries, or properties. More generally, it takes the perspective of capital providers rather than of tax authorities. See Diaz-Berrio (2011).

3.1.5 Publish What You Pay and Revenue Watch Institute

In 1999, Global Witness released a report on oil and corruption in Angola and publicly called on oil companies operating in that country to “publish what you pay.” This was the genesis of the Publish What You Pay (PWYP) campaign, launched in June 2002 by UK-based NGOs and George Soros’s Open Society Institute. The campaign calls for “transparent and accountable management and expenditure of public funds” to address “the poverty, corruption and autocracy that too often plague resource rich countries.”²⁴ Now a coalition of NGOs spanning 60 countries, PWYP has pursued both mandatory and voluntary transparency initiatives at the national and international levels (van Oranje and Parham 2009). The efforts of these NGOs have contributed to major international programming, analysis, and funding focused on these issues.

The Open Society Institute (OSI) has provided crucial support for PWYP through the now-independent Revenue Watch Institute (RWI). The OSI founder, financier George Soros, also helped attract high-level support for the RWI, including from UK Prime Minister Tony Blair (whose government launched the EITI). With a budget of about US\$10 million, a staff of 40, and a large grant-making programme, the RWI has become a cornerstone of policy analysis and capacity building for local advocacy on the extractive sector.²⁵

Other prominent NGOs engaged on these issues include Save the Children, which published the first resource company disclosure assessment, as well as Catholic Relief Services, Christian Aid, Partnership Africa Canada, and Oxfam, all of which have had active roles in advocacy. They have pushed for the diffusion of mandatory financial disclosure beyond the United States through stock-exchange regulators, export credit agencies, disclosure of extractive industry contracts, and stronger standards of due diligence within the resource and financial sectors. One of the major objectives has been to change international accounting standards in the direction of greater transparency, as discussed above, with the expectation that increased transparency will have impacts on IFF.

3.2 Certification instruments

Certification instruments can ensure the legitimacy of resources with respect to multiple criteria, including fair trade and environmental impacts. Many certification schemes involve “commodity-specific tracking regimes” that follow resources through the entire supply chain to ensure due diligence on specific criteria (Crossin, Hayman, and Taylor 2003). Among extractive sectors, most attention to date has focused on so-called conflict resources (resources coming from conflict areas). In comparison, there has been too little specific attention to illicit financial flows.²⁶ Nevertheless, certification focused on illicit financial flows holds some potential, especially with regard to the mispricing of commodities at the point of export, based on commodity valuation processes. As demonstrated in the case of diamonds in Sierra Leone, however, the independence and integrity of valuers is crucial, since valuation itself offers opportunities for corruption.

²⁴ See “History” and “Objectives” on the Publish What You Pay website, <http://www.publishwhatyoupay.org/about/objectives>.

²⁵ In addition to the OSI, principal financial backers of RWI include the Gates Foundation, Hewlett Foundation, and Norwegian Agency for Development Cooperation.

²⁶ More generally, there have been a wide range of certification efforts over the past two decades (Conroy 2007). Almost all, however, have focused primarily on wages and working conditions for workers rather than other issues.

3.2.1 Kimberley Process Certification Scheme

The Kimberley Process Certification Scheme (KPCS) is a voluntary governance scheme through which participant countries commit not to trade in “conflict diamonds” (defined as diamonds coming from rebel-controlled areas). The KPCS was officially created in November 2002 after some three years of negotiations that included most diamond exporting and importing countries, diamond companies, and civil society organisations. Initially motivated by diamond-funded wars in Angola and Sierra Leone, the KPCS sets minimum requirements for the certification of diamonds as “conflict-free.” In addition, participating governments need to ensure that they do not trade in rough diamonds with non-participating countries. National legislation, peer review missions, and the possibility of exclusion or suspension, as in the cases of the Republic of Congo and Zimbabwe, respectively, are intended to support the scheme (Smillie 2010).

The KPCS has brought a degree of transparency to the diamond trade, as the certification process includes data on the volume and value of traded diamonds. Diamond valuation before export, and reconciliation with the estimated import value, limits opportunities for tax evasion through under-invoicing. The KPCS also establishes a more stringent paper trail for points of production, export, and import, thereby reducing the laundering of illegally mined diamonds. Monitoring at the production and domestic trade level, however, is often minimal, which can lead to the laundering of illegally mined diamonds or even conflict diamonds. A sudden and unexplained rise in production or price/carats value normally results in a review to check whether genuine production accounts for such a rise.

Unfortunately, the KPCS has not evolved beyond its initial mandate. Thus, it does not address broader human rights abuses in diamond mining or illicit financial flows resulting from corruption and tax evasion (other than smuggling of conflict diamonds). Given the failures to address issues such as the brutal repression of artisanal mining in Angola or repression and corruption in Zimbabwe, the initiative is now broadly perceived as a missed opportunity if not a failure (Lehr 2010; Blore and Smillie 2011). There are several new initiatives to fill the perceived vacuum.²⁷ One of these, the Diamond Development Initiative International, gives specific attention to the legalisation of financial flows from artisanal mining.

3.2.2 Other certification and commodity tracking regimes

The KPCS generated interest in other extractive sectors, including in countries where a significant amount of oil is stolen and laundered through domestic and international markets. Iraq and Nigeria have been prime targets of this type of policy (Asuni 2009). Fingerprinting Nigerian oil, for example, has been proposed to track illegal diversion and trading (bunkering), with a consultancy company promoting oil certification “to hit the well-organized theft of oil by choking off the market for the stolen oil and interrupting the supply chain.”²⁸ But fingerprinting is unlikely to address bunkering schemes orchestrated by political and security elites in a quasi-official manner. The oil shipped by these elites is coming from legal channels and thus matches export declaration papers (while stolen or bunkered oil would not be recorded at official oil terminals). Fraud by misrepresenting volume rather than the origin of production is the key to such illicit resource flows. Some analysts suggest that

²⁷ Including the Diamond Development Initiative, the Responsible Jewellery Council certification, the No Dirty Gold campaign’s “Golden Rules,” and the Initiative for Responsible Mining Assurance.

²⁸ See the Legal Oil website at <http://www.legaloil.com/>. Fingerprinting is considered in a number of other industries, including gold (Yorke-Smith 2010).

schemes controlled by elites account for the vast majority of illicit oil exports occurring in Nigeria (Adeleye 2011).²⁹

Commodity tracking initiatives have also targeted the illegal exploitation and trade of conflict minerals in eastern DRC (Lehr 2010). Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires SEC-regulated US companies to report on due diligence processes to avoid laundering four minerals—cassiterite, tantalum, wolframite, and gold—from rebel-controlled areas. This requirement sends yet another strong signal to the industry to adopt stricter due diligence practices, with companies having to prove the integrity of their supply chain. As of 20 April 2011, no final rules had yet been issued by the SEC. In response, companies may turn to the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. But they may instead simply shift their supplies away from the DRC. To avoid a de facto embargo while ensuring supply integrity, Partnership Africa Canada has worked with the International Conference on the Great Lakes Region (ICGLR) to create a mineral tracking and certification system for the region (Blore and Smillie 2011). In the timber sector, with a wider geographic scope, the European Union is setting up measures to prevent the importation of illegal timber and to increase demand for “responsible wood products” through forest sector governance agreements with exporting countries under the Forest Law Enforcement, Governance and Trade (FLEGT) scheme.

3.3 Governance initiatives

3.3.1 Natural Resource Charter

Greater awareness of the “resource curse” and resource-related conflicts have focused the attention of the international community on resource governance. In 2008, development economist Paul Collier initiated efforts to formulate international standards in this area through the creation of the Natural Resource Charter (NRC).³⁰ Based on a set of 12 principles defined by a group of academics, the NRC suggests to governments that resource development should take place under open and accountable management, backed by robust fiscal regimes, that maximises sustainable broad benefits for citizens and minimises negative social and environmental impacts. It also suggests that contracts should be awarded competitively and that all relevant actors should operate transparently and according to best practices. Finally, it suggests that resource revenues should be smoothed to reduce volatility and invested domestically so as to foster economic diversification.

The Natural Resource Charter is being actively promoted through broad consultations, and over time it may become the basis of formal intergovernmental or government-company agreements. Adherence to its recommendations would eventually be monitored at the country level. This monitoring will serve as both an indicator of good governance for stakeholders and an incentive for norm adoption by producing governments.

Several recommendations in the Natural Resource Charter are relevant to IFF. Precept 2 on openness and accountability emphasises transparency along the entire decision chain of resource exploitation, an active civil society capable of holding to account governments and companies, and enforceable national and international penalties. Precept 3 on fiscal regimes notes the importance of auditing, access to verifiable variables such as world prices, transparency and uniform rules, enforcement mechanisms, and due diligence on investors. Precept 11, on the role of the international community,

²⁹ This contrasts to an approach that would primarily blame the Nigerian government for failure to control bunkering, while underplaying oil ownership issues and demands from local communities for control over whether or not resources should be exploited (Zalik 2011).

³⁰ See the Natural Resource Charter website at www.naturalresourcecharter.org. Also see Collier (2007).

calls for international standards and regulation of financial centres to limit the leakage of public resources.

3.3.2 Donor governance initiatives for the extractive sector

In the past decade, donors have been active in seeking to improve resource governance. But they generally have little leverage over governments benefiting from large resource revenues. This is particularly the case for large oil producers. From the point of view of the country's population, donor leverage is a double-edged sword. While it can be used to improve governance, it may also be used to help secure better deals for donors' home companies.³¹

Several donor agencies have extractive sector governance initiatives, most notably the World Bank and the Norwegian Agency for Development Cooperation (Norad). A rapid check by this author of relevant sources, in early 2011, showed that more efforts were underway in this area. However, most seemed to be taking the approach of consolidating civil society organisations, while paying less attention to illegal exploitation and tax evasion.³²

The Oil, Gas, and Mining Unit of the World Bank is pursuing several projects aimed at improving resource governance throughout the resource cycle. Particularly relevant are its Extractive Industries Technical Advisory Facility (EI-TAF) and Petroleum Governance Initiative, which at times overlap for petroleum-related projects. This type of assistance is not new, but it has recently been reframed to better address resource curse issues; it now includes consensus building, community development, and revenue management activities. The World Bank gained much experience through its involvement in the Chad-Cameroon Petroleum Development and Pipeline Project; a notable lesson learned was that robust institutions and sound policies need to be in place before oil development begins (see box 4).

Norway's Oil for Development (OfD) programme plays a key role in terms of funding, capacity building, and technical assistance. Norway is the only OECD country implementing the EITI: it hosts its international secretariat and provides core funding for the initiative and funding to civil society participants. It has an ongoing partnership with Revenue Watch Institute. OfD provides capacity building and technical assistance in about 20 countries, including courses on good governance and anti-corruption. It collaborates with the World Bank and with the IMF on tax policy and administration as well as through country-specific advice. Operationally, OfD has assisted countries in running clearer and more transparent licensing and bidding processes, thereby reducing opportunities for corruption. OfD emphasises the need for early and long-term engagement with producing countries.

3.4 Non-resource-specific initiatives

3.4.1 OECD Global Forum on Transparency and Exchange of Information for Tax Purposes

Several intergovernmental initiatives on taxation, including on transfer pricing, are relevant to addressing tax avoidance and evasion in extractive sectors. The OECD Global Forum aims "to ensure that all jurisdictions fully implement the international standards on transparency and exchange of information" for tax purposes. This initiative was started in response to a call from the G20 in 2004 to

³¹ See, notably, the case of Angola (Le Billon 2005).

³² Consultation of relevant websites and personal communications with staff at Oil for Development at Norad and at the US Agency for International Development.

improve tax transparency, and follows on previous OECD initiatives for improving access to overseas bank information by tax authorities.³³

Box 4. Chad's petroleum and illicit financial flows

International efforts to control resource revenue flows and prevent the “resource curse” were most notably tested in Chad. Taking place under a dictatorial regime in one of the world’s poorest countries, the Chad-Cameroon Petroleum Development and Pipeline Project attracted both domestic and international criticism. Eager to reduce risks to its reputation, the Exxon-led project consortium obtained the backing of the World Bank in 2000. The World Bank obtained a commitment from the government of Chad, embodied in Law 001/PR/99, to allocate most of the initial oil revenues to poverty reduction programmes. There was also provision for external monitoring through an International Advisory Group, the World Bank’s Inspection Panel, and monthly publication of oil companies’ royalty payments to the government through an escrow account. The World Bank and an External Compliance Monitoring Group also oversaw an environmental impact mitigation programme.

The transparency and monitoring programme was heralded as a pioneering effort and a model for future oil development. Yet it soon ran up against the realities of a bankrupt and militarised regime, which came under attack from Sudan-supported rebels in 2003 and 2006. The regime of Idriss Déby rescinded the agreement with the World Bank and the law on petroleum revenues it had passed, allocating more funds to defence. The World Bank attempted to put pressure on the government by suspending non-humanitarian aid to the country, but this had little effect. By 2010, Chad produced about 120,000 barrels of oil per day, generating around US\$2 billion in government revenue, 10 times the amount of taxes collected by the government before oil started flowing. While the monitoring scheme supplied a veneer of legitimacy for the pipeline project and reinforced the Chadian regime, the benefits for the population were not realised. Critics noted that the oil project outpaced the development of institutions intended to monitor it. The World Bank lost leverage as oil revenues increased, and both external and internal monitoring entities proved weak and ineffective (Pegg 2006; Winters and Gould 2011).

The Global Forum currently includes 92 countries (101 jurisdictions) and promotes tax information exchange agreements (TIEAs). The number of agreements has increased dramatically since 2008, reaching 600 by March 2011, despite a more stringent review process than previously (OECD 2011a).³⁴ This success has been based on the strong and repeated support of the G20, along with guarantees in terms of confidentiality.³⁵

To date, participation in the Global Forum has been primarily by industrialised countries. Only 10 of the countries in the Global Forum are resource-dependent low- or middle-income countries, including Ghana, Guatemala, Nigeria, and Liberia. Many of the extractive companies operating in developing countries are registered in tax haven jurisdictions, some of which are themselves also Global Forum participants. Yet, with the exception of Liberia, none of the resource-dependent countries in the Global

³³ For more information, see OECD (2011a).

³⁴ Countries can also choose the agreement through double taxation conventions (DTCs).

³⁵ A country can decline to provide information on the grounds of public policy interest, for example, where the information requested relates to a state secret (OECD 2011a).

Forum had signed a TIEA by March 2011.³⁶ Even Liberia failed to sign any agreement with a tax haven jurisdiction, that is, a country listed by the OECD as either not having committed to internationally agreed tax standards or not having substantially implemented them.

Despite these limitations, the Global Forum could help reduce tax evasion originating from extractive sectors in developing countries in several ways. It could encourage the participation of more resource-rich countries. It could assist in identifying jurisdictions potentially routing illicit flows from extractive sectors. And it could facilitate TIEA agreements between resource-rich countries and such jurisdictions. Collaboration with the OECD's African Tax Administration Forum, the IMF, and the World Bank, as well as with NGOs such as Revenue Watch Institute and Financial Accountability and Corporate Transparency (see below), could assist in this regard.

3.4.2 World Bank/IFC Global Tax Simplification Program

The Global Tax Simplification Program (GTSP) of the World Bank and International Finance Corporation (IFC) offers technical assistance with transfer pricing to developing countries. It is considering including mining among its possible priority areas. The assistance programme includes "training on transfer pricing principles and regulations; training on application of transfer pricing; elaboration and preparation of transfer pricing legislation . . . ; audit approach of transfer pricing matters; [and] documentation requirements for taxpayers" (Awasthi 2011). To date, no resource-dependent developing country is among the seven countries receiving transfer pricing assistance. However, about half of the 23 countries in the broader Tax Simplification Program are resource-dependent developing countries.

3.4.3 African Tax Administration Forum

The African Tax Administration Forum (ATAF) is an OECD-sponsored initiative seeking to develop best practices among African tax administrations. It includes a Transfer Pricing Project aimed at a more effective application of the arm's length principle.³⁷ Critics argue, however, that the arm's length principle is ineffective or inadequate, and that African countries (and the OECD) should consider alternatives such as formulary apportionment, whereby "companies are taxed on the basis of their economic activity and income within a particular geographic jurisdiction rather than arbitrary allocation of costs" (Clausing and Avi-Yonah 2007; Sikka and Willmott 2010). This position is rejected by OECD officials, who argue that the arm's length principle is already being applied and that it is adequate.³⁸ ATAF meetings have addressed tax evasion and transfer pricing issues.

3.4.4 Financial Accountability and Corporate Transparency coalition

Officially launched in the United States in April 2011 by 26 CSOs, the Financial Accountability and Corporate Transparency (FACT) coalition is seeking policy change for US-listed companies:

³⁶ Liberia has signed TIEAs with seven European countries plus Greenland and the Faroe Islands. While it is possible that many resource-dependent developing countries may have DTCs addressing information exchange, a rapid survey by the author suggests this is not the case.

³⁷ The arm's length principle is defined in the UN Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention. The principle states that "profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market" (see art. 7 commentary in UN Model Double Taxation Convention). The application of this principle is further supported by the OECD Transfer Pricing Guidelines (OECD 2010).

³⁸ For further discussion comparing the options, see Altshuler and Grubert (2010).

- requiring that ownership information of all business entities, trusts, foundations, and charities—information that indicates who actually controls these entities—be made available to law enforcement and the public;
- requiring country-by-country reporting by multinational corporations of the sales made, profits earned, and taxes paid in every jurisdiction where an entity operates;
- strengthening, standardizing, and enforcing anti-money laundering laws; and
- eliminating loopholes in the US tax system to make sure that the corporations that benefit from the resources, protections, and markets in the United States pay their fair share of taxes.

While FACT has a broad mandate and is currently US-focused, several CSOs in the coalition have a specific interest in extractive sectors, including Global Witness and the Tax Justice Network.

3.4.5 Anti-corruption extraterritorial legal enforcement

There has been recent progress on anti-corruption legal tools and enforcement, including in the United States and, to a lesser extent, in the United Kingdom, Canada, and France. The sharp rise in enforcement of the US Foreign Corrupt Practices Act (FCPA) since 2006 has vastly increased corporate awareness of the liabilities associated with corrupt practices, including in the extractive industry (Koehler 2007; Sulavik 2009).³⁹ Four major cases brought against oil and gas companies have resulted in settlement and penalties of about US\$1.5 billion, the largest in any economic sector. Another set of penalties has been imposed in relation to the oil and gas sector in Nigeria. The extension of anti-corruption enforcement is perceived as necessary in order to reduce the competitive advantage companies might gain through corruption (PwC 2008).

One major issue with FCPA enforcement is that the penalties are paid to the US Treasury instead of compensating the countries which are victims of the corrupt practices. This situation could be remedied in two ways. First, regulations might require the corporations to pay the penalty to the government affected by the corrupt transaction. The risk in this approach is that corruption may end up being doubly profitable for a country: in addition to the bribe payment received by the official, there is the penalty payment, itself much larger than the estimated bribes paid. Second, one might assess the loss resulting from the corrupt transaction and then compensate the country for this loss out of the penalty paid, but only on condition that the corrupt official is prosecuted. This would have several advantages: first, prosecution of corrupt officials and not only corporations paying bribes; second, recovery of losses made; and third, greater awareness of the costs of bribery. There is still the possibility that the government would not see corruption as costly if it is compensated, but this disincentive should be counterbalanced by the heightened awareness of corporations that end up paying the penalties.

3.4.6 Stolen Asset Recovery (StAR) initiative

The Stolen Asset Recovery (StAR) initiative is a “partnership between the World Bank Group and the United Nations Office on Drugs and Crime that supports international efforts to end safe havens for corrupt funds.”⁴⁰ This initiative is engaging with extractive-sector cases and resource-dependent countries, notably through its partnership with Global Witness. It emphasises the crime of illicit enrichment of public officials, as described in Article 20 of the UN Convention Against Corruption (UNCAC). StAR does not appear to address illicit enrichment by corporations through tax evasion,

³⁹ Assessed FCPA settlements and penalties rose from US\$3 million in 2002 to US\$1.75 billion in 2008. The FCPA applies to all US companies, issuers, and employees.

⁴⁰ See “About Us” on the Web page for the StAR Initiative, http://www1.worldbank.org/finance/star_site/about_us.html.

except when it is used by officials to hide stolen assets. The definition of stolen assets, from the perspective of this initiative, thus would include only the revenues illegally gained by public officials through embezzlement or corruption, rather than public assets stolen by corporations in the form of evaded tax.

StAR could consider extending its coverage to some forms of IFF. The initial focus could be placed on a case in which corruption leads to illegal exploitation and tax evasion. Here, collaboration with authorities investigating how corruption facilitates tax evasion, such as agencies implementing the US Foreign Corrupt Practices Act, could be of much value. An extension could seek the recovery of tax avoidance benefits derived from bribery perpetrated by corporations. In this respect, StAR could collaborate with initiatives assisting in the investigation of tax evasion, such as the Global Forum on Transparency and Exchange of Information for Tax Purposes.

3.5 Do these initiatives address the problems of IFF?

The EITI has gained significant momentum and is being reinforced by progress on mandatory country-by-country disclosure in major jurisdictions. With the exception of the EITI and the KPCS, however, the initiatives discussed above are too recent to allow assessment of their achievements. Rather, one can assess their progress in gaining support and make educated guesses about their potential impacts.

Several factors have contributed to the relative success of these initiatives in gaining support and acceptance within the international policy community:

- Greater awareness of the resource curse in the context of the recent commodity boom. Many stakeholders are anxious to ensure that the long-term developmental failure associated with the 1970s commodities boom will not be repeated.
- High-level backing by prominent politicians (especially former UK prime minister Tony Blair) and business leaders (especially George Soros and, in the case of the KPCS, the diamond company De Beers); by several developed countries (especially the United Kingdom and Norway); and by well-funded, well-organised civil society organisations (especially OSI, Global Witness, Partnership Africa Canada, and PWYP).
- In most cases, use of a slow but sustained, constructive, and voluntary multi-stakeholder approach, backed by national legislation once adopted.
- Relative complementarity of these initiatives, embedded in a unifying good governance framework.
- Public pressure due to the legitimacy enjoyed by this cause, making companies reluctant to reject these initiatives publicly. Once an initiative has been adopted, companies can choose either to undermine its application or to help promote its wider adoption to ensure uniform impacts across the industry.

In general, these initiatives have led to somewhat greater transparency and to greater involvement by civil society in this area. However, tangible impacts have yet to be demonstrated. More needs to be done, as suggested below in section 4.

Table 5 presents a comparative assessment of the potential relevance of these initiatives, and table 6 indicates whether their impacts are most likely to be in domestic or international arena.

Table 5. Initiatives and relevance to IFF types

Initiative, by type	Type of IFF		
	Corruption	Illegal exploitation	Tax evasion
Transparency			
EITI	Yes, if transparency and high disaggregation provide significant data and help bring about accountability	Yes, if high-quality volumetric information is provided to facilitate audits on volumes of production and price per volume	Yes, if disaggregated figures by commodity, company, and project are provided for the audits
Dodd-Frank 1504	Yes, if transparency and high disaggregation provide significant data and help bring about accountability	Yes, through information on volumes and prices which could help identify illegal exploitation	Yes, through greater information available on the extractive activities and tax payments of resource companies
IMF Guide on Resource Revenue Transparency	Yes, through greater transparency	Yes, through greater transparency	Yes, through greater transparency
IFRS	Yes, through more disaggregated reporting	Yes, through more disaggregated reporting	Yes, through more disaggregated reporting

Initiative, by type	Type of IFF		
	Corruption	Illegal exploitation	Tax evasion
Certification			
KPCS	No, except as linked to undervaluation	No, except for illegal production by rebel groups and if the definition of “conflict diamonds” is broadened to include illegally mined diamonds	Yes, through the use of independent diamond valuers to prevent fraud on export valuation
OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas	No, except in relation to the channelling of trade towards official channels	Yes, by restricting market access for illegally produced commodities	No, except in relation to tax avoidance through illegal production and trading
Dodd-Frank 1502	Yes, through channelling of trade towards official channels if these are not corrupt	Yes, by restricting market access for illegally produced commodities	No, except in relation to tax avoidance by illegal production and trading
ICGLR certification	Yes, through closer monitoring of practices by officials along the value chain	Yes, by requiring official trading channels to only accept legal production	Yes, by increasing reporting and monitoring along the value chain
Governance			
NRC	Yes, through Precept 2	Limited, through Precept 3	Yes, through Precepts 2, 3, and 11
Donor programmes	Yes, through anti-corruption training (except if this backfires and training is used to perfect corrupt practices)	Yes, but generally has a limited impact	Yes, if donor programmes also target extractive companies and help strengthen audit capacity

Initiative, by type	Type of IFF		
	Corruption	Illegal exploitation	Tax evasion
Other			
TIEAs	Indirectly, through the information provided	Indirectly, through the information provided	Yes, through information exchange
FCPA	Yes, through investigations and voluntary reporting	No, but investigations could reveal illegal practices	No, but could play a greater role in identifying tax evasion practices facilitated by corrupt payments
StAR	Yes, through repatriation of embezzled funds and judicial investigations	No, but could play a positive role if information collected on stolen assets reveals illegal practices	No, except in relation to the proceeds of corruption or embezzlement, although could play a greater role through investigation

Source: Author.

Table 6. Domestic or international focus of initiatives by IFF type

Type of initiative	Type of IFF		
	Corruption	Illegal exploitation	Tax evasion
Domestic	EITI NRC	KPCS ICGLR FLEGT	NRC ATAF GTSP
International	Dodd-Frank 1504 IFRS FCPA StAR	KPCS Dodd-Frank 1502 OECD Guidelines FLEGT	TIEAs IFRS

Source: Author. Note that several initiatives span several IFF types and realms.

4. What more can be done?

In comparison to a decade ago, as this paper shows, much is already being done to curtail IFF. A large number of measures have been adopted, most within a broad good governance agenda emphasizing transparency and accountability through voluntary participatory processes. Several donor countries, such as Norway and the United Kingdom, have played important roles in supporting the emergence and application of these measures, trying to set norms that would benefit local populations in producing countries while avoiding harm to their own resource companies. But, as some authors have noted, donor countries need to “determine clear criteria for success in their interactions with [resource] producing countries” (Al-Kasim, Søreide, and Williams 2008, 28). This section presents some suggestions for donor agencies and other key stakeholders.

4.1 Recommended priorities for current initiatives

There are three broad priorities for current initiatives:

- **Extend transparency and accountability up and down the value chain.** Secure the transparency of licenses and contracts through existing instruments. Engage extractive-sector trading and banking partners in efforts to address the laundering of proceeds and resources from corruption, illegal exploitation, and tax evasion.
- **Move from voluntary to mandatory transparency and translate transparency into accountability.** Continue to promote voluntary participation in disclosure schemes while extending mandatory disclosure instruments beyond current jurisdictions. The equivalent of Section 1504 of the Dodd-Frank Act in the United States should be introduced in all major stock exchange markets, including in the European Union (EU), Canada, Australia, the BRIC countries, and smaller stock exchanges listing resource companies, including those in the Middle East. Establish country-by-country reporting requirements through international accounting standards. Continue to support due diligence on politically exposed persons (i.e., politicians and bureaucrats susceptible to being corrupted or defrauding the state), legality validation, and extension of TIEAs. Create synergies between mandatory disclosure legislation through stock exchanges and the EITI, notably through data sharing.
- **Connect anti-corruption, illegal exploitation, and tax agendas.** Foster dialogue between policy makers in these different areas. Identify options for synergies between increased revenues from taxation, formalisation of illegal exploitation, and anti-corruption reforms.

With these three priorities in mind, several specific suggestions can be made for existing initiatives as well as for actors such as donors and NGOs.

4.1.1 Transparency initiatives

The EITI is likely to remain the main transparency initiative for extractive sectors. Its success is crucial and will likely build on stricter disclosure legislation and accounting standards. Success may also result from further work in five areas, as described below.

First, as noted earlier with respect to the relative failure of the KPCS, the EITI will need to evolve to maintain both credibility and support. Transparency should not be confined to *revenues*: as the title indicates, the scope of the initiative is broader than that. Transparency should be extended to other domains, including:

- *Licenses and contracts:* Risks of international financial flows can be identified in contracts if those are made publicly available and are assessed by fiscal experts. Donor agencies can help by supporting contract disclosure campaigns and related initiatives and regulations, including through export development credit agencies; providing financial support for expert

assessments (including through the World Bank's EI-TAF); and building up the capacity of international NGOs assisting local CSOs seeking independent opinions on contracts signed (e.g., Global Witness, Tax Justice Network).⁴¹

- *Resource flows*: Before tackling illicit *financial* flows, there is a basic need to address illicit *material* flows. The question to be answered is whether volumes of production and export are reliably measured and officially reported. An EITI auditor stressed that volumetric assessments was a priority in many countries.⁴² The 1999–2004 Nigeria physical audit recommended that in order “to address the question of unaccounted oil . . . a suitable information system mainstreamed into the companies’ information and reporting systems needs to be established to provide the data, without resorting to ad hoc exercises” (Hart Group 2006, 4). Donor agencies can help in this regard by promoting physical audits as part of EITI compliance criteria, with requirements that companies reconcile financial and physical (annual mass balance⁴³) statements; supporting audits of measurement practices to identify gaps, opportunities for fraud, and corruption; fostering professional training on measurement and support for equipment; and identifying sources of information and partnerships that can help identify illicit material flows (e.g., comparisons of imports to exports). The experience of the Joint Oil Data Initiative is a relevant example.⁴⁴
- *Resource prices*: Greater transparency in markets, and notably on prices, is recognised as a positive factor for reducing IFF (as well as possibly reducing price volatility). Donor agencies can help facilitate access to price information by helping regulators and CSOs know about prices. They can also facilitate price assessments and tax audit follow-up through the Global Forum on Transparency and Exchange of Information for Tax Purposes.
- *Corporate reporting on a country-by-country basis*: Much deserved attention has already been given to this requirement, and the EITI is not the only instrument here (see Section 1504 of Dodd-Frank in particular). Donor agencies can help by supporting international and domestic initiatives seeking to bring about country-by-country disclosure.
- *Staff remuneration and incentive structure*: Individual incentives contribute to shaping corporate behaviour and some incentives may promote illicit financial flows, in particular tax evasion. Many companies have set strict corporate guidelines to prevent corrupt practices by their staff; similar guidelines could be issued with regard to tax avoidance and evasion practices, especially for personnel in sensitive positions such as accountants and commodity traders. Donor agencies could pursue a disclosure agenda in this area, for example through advocacy NGOs or intergovernmental initiatives on corporate social responsibility. This could be considered for inclusion into the EITI.

Second, transparency initiatives need to go beyond the assessment and collection of revenue on the “upstream” side to look into the *expenditure* side. Greater disclosure will help citizens learn “how much their country earns from resource extraction [and] also whether this amounts to a fair deal,” but it can also inform them as to whether revenues are spent efficiently and equitably (PWYP 2011). The EITI should continue linking with broader governance initiatives such as the Natural Resource Charter to promote transparency and accountability further down the revenue flow. Constraints to such moves include not only political and commercial interests that feel threatened but also the concern that broader coverage will result in reduced depth.

⁴¹ Liberia and Mongolia have published contracts as part of their EITI processes, for example, and made such disclosure mandatory by law.

⁴² Interview with the author, EITI Global Conference, Paris, March 2011.

⁴³ This is the set of volumetric data allowing for the calculation of the sum of resource withdrawals from a deposit, or volume passed through a particular node in the supply chain, over one year.

⁴⁴ For more information, see the UN Statistics Division website at <http://unstats.un.org/unsd/energy/jodi.htm>.

- *Assessment of the scope of initiatives:* A first implication is that EITI members, board members, and supporting countries should carefully follow trends in participation and depth of implementation to assess the scope for broadening the initiative. Donor agencies could support studies tracking trends in the depth and coverage of the EITI, as well as gaps and overlaps with mandatory instruments.
- *Crisis preparedness:* A second implication is that one should anticipate and prepare for specific crises that could undermine the initiative (as Zimbabwe did for the KPCS). Donor agencies could help define coordinated responses to any crisis that may arise, such as compliance default by a “compliant” country, by linking with the EITI board.
- *Follow-up on legislation:* A third implication is that the EITI should extend its scope in parallel with mandatory legislation, so that the two approaches legitimate and reinforce each other while helping to close gaps in transparency requirements for some countries or companies. Donor agencies could support studies tracking the evolution of the coverage of these instruments.

Third, the breadth and depth of domestic audits should be increased to cover *tax issues*, perhaps at the instigation of members of the national stakeholders groups or in linkage with domestic tax audits. International auditors and the audit agencies of the home governments of corporations could assist. Audits should focus on sectors or cases where they will likely bring high returns. Constraints include the resistance of many governments (and companies) to highly disaggregated reports, the high costs of such audits, and the informal character of revenues in small-scale mining. Three steps should be taken:

- *Build up mandatory audit requirements:* As the most important step, the EITI should strengthen mandatory auditing requirements, requiring higher levels of disaggregation and including physical reconciliation.⁴⁵ This should be facilitated by mandatory stock exchange disclosure requirements and international accounting rules discussed below. Donor agencies could consider further supporting the adoption of these instruments, for example through aid coordination bodies or joint letters of support, akin to the support provided by the EU council and parliament (see Joly and Pietikainen 2011; European Council 2010, 5).
- *Increase assistance to domestic audits:* It is also important to find ways to reduce the costs of audits and increase financial assistance for audits in the poorest countries. The European Council called on EU Member States to work towards “reducing incorrect transfer pricing practices, including by paying special attention to the development of local audit capacities [and] to help developing countries to assess liabilities of their taxpayers at low cost” (European Council 2010, 4). Donor agencies could consider further integrating extractive sector auditing into their capacity-building and budgetary support projects.
- *Formalise illegal mining:* Small-scale mining and other extractive activities often deemed “illegal” should be formalised. Donor agencies could consider further assistance to formalisation projects, such as those coordinated by the World Bank’s Communities and Small-Scale Mining initiative.

Fourth, with access to more disaggregated data and an extended audit mandate, EITI could broaden its focus from revenue transparency to include illegal exploitation and tax evasion. EITI audits could also be mandated to more vigorously investigate the *causes of discrepancies and the location of unaccounted resources and funds*. This would of course be difficult, given sovereignty concerns. One

⁴⁵ Physical reconciliation would aim at identifying illegal resource flow diversions by collecting and comparing volumetric information from companies and authorities that may have a vested interest in misreporting. Volumetric information includes raw volumetric data as well as “reconciliation factors.” These are indicators assisting in the calculation of financial or physical diversions, such as the ratio of volumetric outflow to inflow, or variations in oil flow rates in a pipeline.

option is to use credible domestic institutions if available, ideally the chief auditor's office or the judiciary, to carry out follow-up investigations. There are also several models of peer-review mechanisms, including KPCS and regional organisations. Donor agencies could provide assistance in conducting domestic or international investigations, possibly through the EITI or through the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Fifth, as noted by Gillies (2010) and many participants in the 2011 EITI Global Conference, *translating transparency into accountability* is now a clear priority. Greater access to information is required. But the information also needs to be used appropriately to increase accountability, at the international level by making comparisons and at the subnational and national levels through (local) accountability mechanisms. Donor agencies can help by fostering the creation of a global extractive sector revenue information platform, and by continuing to support outreach by CSOs in producing countries.

Finally, a major success of the EITI has been to create multi-stakeholder groups at both national and international levels. Despite the criticism that domestic civil society groups have been co-opted or marginalised, on balance the EITI has already played a positive role for civil society organisations, providing them with a safer domestic context in which to demand greater transparency and accountability. The greatest emphasis has been placed on local CSOs, however, with less attention to formal accountability institutions, both in the domestic arena (such as judges, general auditors, and parliamentarians) and internationally (such as regional peer review mechanisms and overseas courts with extra-territorial jurisdictions).⁴⁶ Local authorities and CSOs could also make greater use of international initiatives to fight tax avoidance and evasion, such as the International Tax Compact. Donor agencies could encourage a broadening of accountability mechanisms and institutions beyond supporting local CSOs.

4.1.2 Tax enforcement initiatives

To date, the EITI has not focused extensively on taxation issues, such as “tax justice” (on the level of taxation) and “tax avoidance and evasion” (on the aggressive or illegal practices of resource companies, including national oil companies). The Natural Resource Charter sets out some relevant precepts in this regard, notably with regard to the taxation and regulation of national resource companies. Donors could encourage studies, outreach, and implementation monitoring on tax-related issues, including through the NRC. In this regard, the tax authorities of developed countries could more rigorously audit their home companies to detect tax evasion, including transfer mispricing.

More broadly, with regard to illegal tax practices, the Global Forum on Transparency and Exchange of Information for Tax Purposes is the leading international initiative to address tax evasion for extractive sectors. Its success is crucial. However, the current piecemeal approach, focused on bilateral agreements via TIEAs and DTCs, has been criticised by those who would like to see a global instrument applied to all (Christian Aid 2009a). Donor agencies could help by financing a review of incorporation jurisdictions for extractive companies and trading partners of countries suspected of being the victims of tax avoidance and evasion. This study could in turn be used to encourage producing governments and the authorities of offshore financial centres to pass TIEAs.⁴⁷ Donor

⁴⁶ As suggested in a review of transparency of extractive companies listed on the Canadian stock exchange, the problem is not simply the availability of data but also the motivation and capacity of civil society to make use of it (Woodside 2009).

⁴⁷ The head of the Global Forum secretariat notes that while the Global Forum “[does] not have an active policy of pursuing specific categories of jurisdictions, a process exists for any member to identify any jurisdiction that can be of relevance to the Global Forum’s work. Jurisdictions that have been identified so will be invited to become members and scheduled for a peer review (which will take place regardless of whether they agree to

agencies could invite more resource-rich countries to join the Global Forum and help them sign and implement relevant TIEAs with these jurisdictions. Collaboration with ATAF, the IMF, the World Bank, as well as NGOs such as RWI and FACT (see below) could assist in this regard.

4.2 Areas for action beyond international revenue governance initiatives

Beyond revenue governance initiatives, there are four additional ways in which donors may make active contributions.

4.2.1 Extend and enforce anti-corruption legislation

Thanks to the UN Convention Against Corruption and the OECD/Asian Development Bank Anti-Corruption Initiative, many countries are now obligated to enforce stricter standards against corrupt practices. Yet, while many governments have shown concern about corruption within their jurisdiction, they have been more lenient with regard to the activities of their companies overseas. (In the United States, for example, there are discrepancies between domestic criminal offences and activities defined as predicate offences for the purposes of anti-money laundering statutes.) There is a need to ascertain and extend the reach of anti-corruption extraterritorial measures for BRIC countries and emerging economies. This need is particularly acute because the current situation, with relatively heavy enforcement directed at US companies, is resulting in a uneven competitive playing field that could undermine long-term anti-corruption efforts. Donor agencies could support a review of foreign bribery among BRIC and emerging countries with large foreign direct investments in the extractive sector or resource-trading activities.⁴⁸

4.2.2 Address IFF in national resource companies

National resource companies, mostly in the oil sector, are a major concern for IFF due to regulatory conflicts of interests, lack of anti-corruption programmes, and low levels of disclosure. Blanket accusations of misgovernance, including corruption, are sometimes overstated, but real concerns exist (Lahn et al. 2007; Luong and Weinthal 2010; Tordo 2011). Donor agencies could further prioritise this area of work, learning from the engagement of the Foster project (UK Department for International Development's Facility for Oil Sector Transparency) in Nigeria. In contrast to the mechanism in Chad, this initiative also seeks to build capacity for greater transparency and accountability, including through day-to-day management assistance (hence the name "foster").

4.2.3 Restrict contracts to companies incorporated in fair-tax and high-disclosure jurisdictions

Resource contracting with companies registered in, or routing their profits through, no-tax or low-tax jurisdictions that offer little disclosure and lack relevant tax treaties presents a challenge to the tax authorities of developing countries, as well as those of the home governments of resource companies. Donor agencies could help inform developing countries of the risk associated with this practice and of the positive implications of greater disclosure. They can also put pressure on their home companies to end tax avoidance and evasion practices.

become members)." Such a review would include an examination of the exchange-of-information agreements these jurisdictions have signed. Personal communication with the author, April 2011.

⁴⁸ For the example of China, with respect to anti-corruption in general, see Fagan (2011).

4.2.4 Promote the ethics of tax payment maximisation in the poorest resource-producing countries

Ethical funds assessments and internal corporate social responsibility (CSR) now represent important factors in corporate behaviour. But there is a need for greater focus on promoting ethical funds assessments and CSR statements that push corporations to maximise tax payments in the poorest countries. Again, country-by-country disclosure would make such a focus possible. While companies would still aim to minimise global tax payments, such a standard would also encourage maximizing taxes in the poorest countries. This could help counterbalance existing incentives to invest in low-risk, low-tax countries, which often happen to be wealthier countries, or to transfer taxable profits into wealthy low-tax jurisdictions. Donor agencies could consider options to increase ethics-driven incentives for extractive companies to maximise tax payments in the poorest producing countries.

In conclusion, curbing illicit financial flows from extractive sectors is a high-stakes endeavour. These flows are massive and are closely connected with governance and developmental issues in producing countries and internationally. Extractive sector revenue issues have gained increasing attention over the past decade, and some significant progress has been made. Some of the initiatives reviewed in this report are already transforming the development potential of resource-dependent economies and reshaping relations between resource-exporting and -importing countries. Yet much more can and should be done, particularly with respect to overlooked components of the extractive sector related to illicit financial flows, such as tax evasion and revenue expenditure.

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This U4 Issue is also available at:
www.u4.no/publications

INDEXING TERMS:

Illicit financial flows
Extractive industries
Corruption
Illegal exploitation
Tax evasion
Natural resources
Zambia
Nigeria
Democratic Republic of Congo

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Countries highly dependent on natural resources are among the most severely affected by the problem of illicit financial flows. Despite a lack of definite studies proving the correlation between higher dependency on natural resources and higher levels of illicit flows, there are grounds to believe extractive industries' revenues provide a large contribution to these flows. Most existing initiatives to address governance issues in extractive sectors have not been designed with the problem of illicit financial flows in mind. They have generally contributed to increased levels of transparency in the sector but have not significantly influenced the likelihood that revenues from natural resources will be misappropriated and illicitly transferred. But extractive industries initiatives can be improved in this regard, and development aid, along with other stakeholders, can help. Among other priorities, transparency initiatives should demand higher disaggregation of information disclosed by extractive companies and host governments. Transparency requirements should extend beyond revenues to licensing, contracts, physical resource flows, and other production factors, as well as to public expenditure. Extractives transparency initiatives also need to integrate elements of the tax justice and tax evasion agendas in order to expand their relevance to the effort to reduce illicit financial flows.